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ZNR UUUUU ZZH
R 150835Z MAR 06
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TO RUEHC/SECSTATE WASHDC 9096
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUCPDOC/USDOC WASHDC
RUEHBK/AMEMBASSY BANGKOK 3194
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TREASURY FOR OASIA/LMOGHTADER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A

TAGS: EINV EFIN ECON PINR TW

SUBJECT: Central Bank Short-term Liabilities Prevented BOP Deficit
in 2005

Ref: Taipei 711

SUMMARY

¶1. Taiwan in 2005 had a trade surplus of US\$18 billion, which more than offset its services trade deficit and net capital outflow, and which pushed up Taiwan's foreign exchange (FX) reserves by 4.8% to US\$253 billion. However, Taiwan would have had a negative Balance of Payments (BOP) in 2005 if the central bank had not made repurchase agreements to meet growing FX demand. An export surge beginning in Q4 of 2005 may bring Taiwan another trade surplus in Q1 of 2006. However, higher overseas interest rates and credit/cash card debt issues (reftel) may drive foreign investors away and bring about a BOP deficit later this year. End Summary.

Current Account (C/A) Surplus

¶2. In 2005, Taiwan had a current account (C/A) surplus of US\$16.37 billion. Nearly 60% of the 2005 C/A surplus was produced in Q4 when an export boom drove up year-on-year (y-o-y) export growth to 14%, substantially higher growth than the 6-7% in the previous three quarters. The 14% export growth, coupled with a 23% drop in capital goods imports, contributed to a trade surplus of US\$8.4 billion in Q4. For the entire year 2005, Taiwan's exports grew 8.8% to US\$188.4 billion, while its imports rose 8.5% to US\$170.4 billion. The 2005 trade surplus (based on BOP data) expanded 11.5% to US\$17.99 billion.

13. The 8.8% export growth in 2005 resulted from an expansion of exports to Asian nations. In 2005, Taiwan's shipments to the United States and Europe leveled off, but its exports to Greater China (including Hong Kong), and to ASEAN grew by 12% and by 14.5% respectively. Exports to Greater China and ASEAN in 2005 expanded to 51.6% of Taiwan's total exports from 49.8% in 2004, compared to a decline in the combined export share to the United States and Europe from 29% to 27%.

Foreign Investors Repatriate Earnings

14. The 11.5% decline in Taiwan's C/A surplus in 2005 resulted from a sharp increase in repatriation of earnings by foreign investors and a decline in services income. Foreign investors repatriated 105% more earnings in 2005 than 2004. In 2005, earnings from "direct" investment in Taiwan by foreign companies increased 68% to US\$3.6 billion. Meanwhile, dividends and profits distributed to foreign "portfolio" investors shot up 148% to US\$1.92 billion.

15. Taiwan's Central Bank of China (CBC) and Taiwan companies still had substantial income earned overseas in 2005. Interest income from Taiwan's FX reserves grew 10% to US\$12.25 billion, more than foreign investors total earnings of US\$7.85 billion from direct investment and portfolio investment in Taiwan. In 2005, Taiwan firms repatriated US\$3.9 billion of earnings from direct investment, 33% more than in 2004, and larger than the US\$3.6 billion earned by foreign firms from their direct investment in Taiwan.

Services Income Declines

16. Taiwan's services income in 2005 declined 12% to US\$12 billion. A growing number of Taiwan manufacturing firms take orders in Taiwan, but manufacture and ship products from China, and keep the services income in Taiwan. However, weak demand dampened exports from Taiwan and from China (affecting Taiwan's services income) in the first three quarters of last year. Based on Taiwan's customs data, y-o-y export growth slipped from 35% in Q2 of 2004 to 7.8% in Q1, 5.8% in Q2 and 7.1% in Q3 of 2005. Y-o-y growth in exports to China slipped steadily to 5% in May 2005 from nearly 50% a year ago, and the growth rate did not recover until Q4 last year.

Capital Outflow

17. Taiwan's financial account (F/A) reported a surplus of US\$1.8 billion, down 74% from 2004 due to large capital outflows. Higher interest rates overseas prompted local capital to seek higher returns overseas. Foreign stocks, foreign corporate bonds, and foreign government bonds purchased by Taiwan residents in 2005 totaled US\$35.8 billion, up 52.3% from 2004. Taiwan life insurance companies became major buyers of these investments in order to address their "interest rate loss" arising from the gap between higher rates (6-7%) guaranteed to life insurance policies buyers some years ago and lower current domestic interest rates, down to 1.5-2.0% early last year.

18. Taiwan banks also pursued better earnings from overseas. They offered loans to foreign customers and purchased foreign corporate bonds and foreign government bonds. Net capital outflow from Taiwan banks in 2005 totaled US\$12.4 billion, more than double the net outflow of US\$5.2 billion in 2004.

Taiwan's Stock Market Attracts Foreign Investors

19. While local capital flowed out, Taiwan's stock market attracted a huge amount of foreign investment funds. In response to Taiwan's elimination of the qualified foreign institutional investor (QFII) system and deregulation efforts, Morgan Stanley Capital International (MSCI) raised the weight of Taiwan firms in its international stock price index from 0.75 to 1 in May 2005. As a result, net inflow of foreign portfolio investment funds in 2005 shot up 80.5% to US\$31.3 billion (still less than the NT\$35.8 billion in net capital outflow). Foreign portfolio investors' ownership in local companies listed on the stock market increased

from 18.8% in October 2004 to 32.4% in December 2005.

Direct Investment Flows Decline

¶10. In 2005, Taiwan's direct investment abroad declined 15.6% to US\$6.0 billion, and foreign direct investment in Taiwan declined 14.4% to US\$1.6 billion. An increase in facility utilization rates in Q4 indicates inward and outward direct investments will increase in 2006.

Central Bank Intervention...

¶11. Because of the Central Bank's repurchase agreements, Taiwan's Financial Account avoided a deficit in 2005. The CBC obtained US\$9.5 billion in short-term liabilities through repurchase

agreements using its stock of U.S. bonds. These transactions turned the F/A from what would have been negative US\$7.5 billion to a positive US\$1.8 billion in 2005. The CBC used the proceeds from the short-term liabilities to meet the large FX demand from local banks.

According to the CBC, the International Monetary Fund guidelines permit the practice, which involves little risk.

...Prevents BOP Deficit

¶12. Without the CBC repurchase agreements, Taiwan's BOP would have been in deficit in Q2 last year, and the BOP deficit would have increased from US\$300 million in Q2 to US\$3.1 billion in Q3 and US\$1.1 billion in Q4.

¶13. The CBC repurchase agreements contributed to a quick increase in Taiwan's outstanding short-term external debt from almost nothing a year ago to US\$12 billion by September 2005, equivalent to 3.5% of Taiwan's GDP.

Prospect

¶14. An export boom beginning Q4 last year may bring Taiwan another trade surplus and C/A surplus in 2006. However, local capital will continue to flow out towards higher returns unless the CBC narrows the interest rate gap. The current export boom should make Taiwan attractive to foreign investors, but credit/cash card debt issues (reftel) may discourage foreign portfolio investors and lead to a net outflow of portfolio investment and a BOP deficit.

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